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**Political Connections of the Boards of Directors
and Defense Contractors' Excessive Profits**

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Preface & Acknowledgements

Welcome to our Tenth Annual Acquisition Research Symposium! We regret that this year it will be a “paper only” event. The double whammy of sequestration and a continuing resolution, with the attendant restrictions on travel and conferences, created too much uncertainty to properly stage the event. We will miss the dialogue with our acquisition colleagues and the opportunity for all our researchers to present their work. However, we intend to simulate the symposium as best we can, and these *Proceedings* present an opportunity for the papers to be published just as if they had been delivered. In any case, we will have a rich store of papers to draw from for next year’s event scheduled for May 14–15, 2014!

Despite these temporary setbacks, our Acquisition Research Program (ARP) here at the Naval Postgraduate School (NPS) continues at a normal pace. Since the ARP’s founding in 2003, over 1,200 original research reports have been added to the acquisition body of knowledge. We continue to add to that library, located online at www.acquisitionresearch.net, at a rate of roughly 140 reports per year. This activity has engaged researchers at over 70 universities and other institutions, greatly enhancing the diversity of thought brought to bear on the business activities of the DoD.

We generate this level of activity in three ways. First, we solicit research topics from academia and other institutions through an annual Broad Agency Announcement, sponsored by the USD(AT&L). Second, we issue an annual internal call for proposals to seek NPS faculty research supporting the interests of our program sponsors. Finally, we serve as a “broker” to market specific research topics identified by our sponsors to NPS graduate students. This three-pronged approach provides for a rich and broad diversity of scholarly rigor mixed with a good blend of practitioner experience in the field of acquisition. We are grateful to those of you who have contributed to our research program in the past and encourage your future participation.

Unfortunately, what will be missing this year is the active participation and networking that has been the hallmark of previous symposia. By purposely limiting attendance to 350 people, we encourage just that. This forum remains unique in its effort to bring scholars and practitioners together around acquisition research that is both relevant in application and rigorous in method. It provides the opportunity to interact with many top DoD acquisition officials and acquisition researchers. We encourage dialogue both in the formal panel sessions and in the many opportunities we make available at meals, breaks, and the day-ending socials. Many of our researchers use these occasions to establish new teaming arrangements for future research work. Despite the fact that we will not be gathered together to reap the above-listed benefits, the ARP will endeavor to stimulate this dialogue through various means throughout the year as we interact with our researchers and DoD officials.

Affordability remains a major focus in the DoD acquisition world and will no doubt get even more attention as the sequestration outcomes unfold. It is a central tenet of the DoD’s Better Buying Power initiatives, which continue to evolve as the DoD finds which of them work and which do not. This suggests that research with a focus on affordability will be of great interest to the DoD leadership in the year to come. Whether you’re a practitioner or scholar, we invite you to participate in that research.

We gratefully acknowledge the ongoing support and leadership of our sponsors, whose foresight and vision have assured the continuing success of the ARP:



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Political Connections of the Boards of Directors and Defense Contractors' Excessive Profits¹

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Abstract

Despite the fast-growing interest in the research of *political connections* of either private-sector firms or states, most of the papers belong to the economics or public administration fields. There are few studies, if any, that look into the role of firms' political connections in the defense acquisition area. This paper makes an effort to bridge this gap by investigating the impact of political connections on the excessive profitability of defense contractors.

Wang and San Miguel (2012) documented that defense contractors earn excessive profits relative to their industry counterparts. This study extends Wang and San Miguel (2012) and examines whether defense contractors' political connections (as measured by the prior employment histories of the board directors) influence contractors' excessive profitability. We find that, in contrast to the prediction of "corruption hypothesis," the excessive profits are less (more) pronounced for those contractors with politically connected (non-connected) boards. This casts doubt on the preconceived notion that those politically connected board members are corrupt in nature; rather, our findings suggest that they may use their experience to serve a benevolent role to the public in keeping defense contractors from opportunistic profit-seeking behaviors that could reach or even cross the federal government's regulatory redline.

Introduction

*Political connections*² of either private-sector firms or public states has increasingly become a popular research topic among economists, business and public administration scholars, and political scientists. For example, in regard to states' political connection as measured by representation in the U.S. Congress, scholars have documented that per capita federal expenditures at the state level are positively related to per capita Senate representation, which gives rise to a small state advantage (Atlas, Gilligan, Hendershott, & Zupan, 1995). No similar advantage is found if data is restricted to earmarks secured in House appropriations bills³ (Hoover & Pecorino, 2005; Knight, 2008). This seems to suggest that political connection does matter from a state's perspective.

Naturally, a similar research question exists for private-sector firms: that is, do politically connected private-sector firms derive economic benefits from such a relation? Most studies intended to answer this question somewhat support this conjecture. For instance, Goldman, Rocholl, and So (2009) demonstrated that the market responds positively (i.e., a positive abnormal stock return is observed) to the announcement of the

¹ JEL Classifications: G38, H57, M48.

² There is no consensus regarding the definition of *political connection*. Definitions vary with specific studies.

³ Note that each state has two senators, regardless of the population of the state. The representation in the U.S. House, however, is based on state population.



nomination of a board member who is politically connected from his or her prior employment history in the federal government, military services, or as a former representative of the U.S. Congress. Duchin and Sosyura (in press) investigated application data for Troubled Asset Relief Program (TARP) funds and found that those firm applicants with political connections⁴ were more likely to be funded. Correia (2012) found that for firms with irregular accounting practices, those with political connections are less likely to become the target of Securities and Exchange Commission (SEC) investigation, and if they are indeed investigated, they face lower penalties on average than non-connected firms. Khwaja and Mian (2005) used Pakistan banks' corporate lending data to show the rent-seeking behavior of politically connected firms. In particular, they found that "political firms borrow 45 percent more and have 50 percent higher default rates. Such preferential treatment occurs exclusively in government banks—private banks provide no political favors" (p. 1371). It is also worth mentioning that these studies not only document the real impacts of political connections, but they also share a common theme suggesting that political connections are a source of corruption and underlie various rent-seeking behaviors. Simply put, political connections matter in a negative way.

Despite the fast-growing interest in the research of political connections, most of the papers belong to the economics, political science, or public administration field. There are few studies, if any, that look into the role of firms' political connection in the defense acquisition area, which provides another proof of the alleged disciplinary disconnect⁵ that has existed for a long time.

The objective of this paper is twofold. First, we attempt to bridge the gap that exists between defense acquisition study and other relevant research fields, such as economics and public administration. As observed by many academicians and practitioners, such a disengagement of defense acquisition research (with other fields) is both unfortunate and unjustified. The society will be better served if such a disconnection is mitigated. Toward this goal, we build on the extant literature and aim to investigate the impact of political connections (an established concept in non-defense research) on a very important topic in defense acquisition, that is, the excessive profitability of defense contractors. Specifically, Wang and San Miguel (2012) documented that defense contractors earn excessive profits relative to their industry counterparts. This study extends Wang and San Miguel (2012) and examines whether defense contractors' political connections (as measured by the prior employment histories of the board directors) influence contractors' excessive profitability.

Our second goal is to test the "corruption hypothesis of political connections" that has been suggested by existing literature in a very particular and essential setting, that is, the nation's biggest defense contractors' excessive profitability. If the results support the

⁴ The definition of political connection in Duchin and Sosyura (2012) takes several forms, including lobbying, campaign contributions, and employment history of directors.

⁵ Such disconnect exists between public administration and military administration (Albano, Snider, & Thai, 2012), and more generally, between economics and military-related research (Rogerson, 1994). Rogerson (1994) stated, "Defense procurement is unique among regulated industries in the United States in that economists have played virtually no role in helping shape its regulatory practices and institutions. Perhaps this is due to the barrier to entry created by the need to first learn about procurement practices or to a lingering distaste for military matters among academics. Whatever the reason, this lack of economic input is unfortunate, because many of the regulatory and policy issues in defense procurement involve the types of incentive issues that economists are very good at analyzing. My own hope is that economists are on their way to colonizing this new policy frontier and that some of the ideas discussed in this article will play a role in shaping policy debates over the next decade" (p. 87).



corruption story, then political connections would become a very serious concern of policy-makers because defense spending is a substantive portion of government expenditures. On the other hand, if such a conjecture is not grounded, what are the findings and what is the explanation?

The remainder of the paper is organized as follows. The section titled Sample describes our sample. The section titled Measuring Political Connections and Hypotheses Development introduces the measure of political connections, followed by the development of hypotheses on the relationship between excessive profitability and political connections, based on extant literature and observations. Empirical results and findings are in the section titled Empirical Results and Findings. The final section concludes the paper.

Sample

We start with the same sample used in Wang and San Miguel (2012). Specifically, they use fedspending.org as the data source to identify the top 500 recipients of defense contracts for 2008. Out of these top 500 firms, 112 are traded on public stock exchanges. These 112 public firms became the main sample of their analyses. Our sample is a reduced version of Wang and San Miguel (2012) in that we delete 16 firms that are missing from the Corporate Library database, which we use to identify the political connections of each firm's board members. Table 1 lists the name, dollar awarded, rank, stock ticker, SIC code, and public stock exchange code for these 96 public firms.

Table 1. Firms in The Main Sample: 96 Public U.S. Firms From the 2008 Top 500 list

Company Name	Contracted_dollars_2008	Rank	Stock Ticker	SIC	EXCHG (11=NYSE, 12=AMEX, 14=NASDAQ)
LOCKHEED MARTIN CORP	\$29,363,894,334	1	LMT	3760	11
NORTHROP GRUMMAN CORP.	\$23,436,442,251	2	NOC	3812	11
BOEING CO.	\$21,838,400,709	3	BA	3721	11
RAYTHEON CO.	\$13,593,610,345	6	RTN	3812	11
GENERAL DYNAMICS CORP.	\$13,490,652,077	7	GD	3790	11
UNITED TECHNOLOGIES CORP.	\$8,283,275,612	8	UTX	3720	11
L-3 COMMUNICATIONS HOLDINGS	\$6,675,712,135	9	LLL	3663	11
KBR INC.	\$5,997,147,425	10	KBR	1623	11
NAVISTAR INTERNATIONAL CORPORATION	\$4,761,740,206	11	NAV	3711	11
ITT CORPORATION	\$4,355,423,578	13	ITT	3812	11
SCIENCE APPLICATIONS INTL CORP	\$3,885,932,047	14	SAI	7373	11
GENERAL ELECTRIC COMPANY	\$3,518,136,891	15	GE	9997	11
COMPUTER SCIENCES CORP.	\$3,230,197,590	16	CSC	7370	11
HUMANA, INC.	\$2,952,008,623	18	HUM	6324	11
TEXTRON, INC.	\$2,827,900,303	19	TXT	3721	11
HEALTH NET, INC	\$2,438,349,117	21	HNT	6324	11
URS CORP.	\$2,402,033,979	22	URS	8711	11
HEWLETT-PACKARD CO.	\$1,938,638,634	26	HPQ	3570	11



ALLIANT TECHSYSTEMS, INC.	\$1,928,045,694	27	ATK	3480	11
OSHKOSH TRUCK CORP.	\$1,863,726,822	30	OSK	3711	11
HARRIS CORP.	\$1,841,470,263	31	HRS	3663	11
HONEYWELL, INC.	\$1,721,547,997	33	HON	3728	11
FORCE PROTECTION INDUSTRIES, (INC)	\$1,360,427,189	36	FRPT	3790	14
CACI INTERNATIONAL INC	\$1,324,104,004	37	CACI	7373	11
AMERISOURCE BERGEN CORP	\$1,298,059,841	38	ABC	5122	11
ROCKWELL COLLINS	\$1,290,813,364	39	COL	3728	11
SHAW GROUP, INC.	\$1,162,267,243	40	SHAW	8711	11
VALERO ENERGY CORPORATION	\$1,043,869,551	43	VLO	2911	11
JACOBS ENGINEERING GROUP INC	\$951,295,410	45	JEC	1600	11
VSE CORP.	\$910,970,473	47	VSEC	8711	14
MCKESSON CORPORATION	\$903,799,326	48	MCK	5122	11
CARDINAL HEALTH INC	\$856,333,988	50	CAH	5122	11
DELL COMPUTER CORPORATION	\$852,813,703	51	DELL	3571	14
EXXON MOBIL CORP.	\$836,548,150	52	XOM	2911	11
MANTECH INTERNATIONAL CORP	\$655,579,972	61	MANT	7373	14
FLIR SYSTEMS, INC	\$507,944,847	71	FLIR	3812	14
GOODRICH CORPORATION	\$487,753,671	73	GR	3728	11
TETRA TECH, INC.	\$472,960,770	77	TTEK	8711	14
IBM CORP.	\$438,446,918	81	IBM	7370	11
PERINI CORP.	\$436,363,793	82	TPC	1540	11
FLUOR CORP.	\$430,878,065	84	FLR	1600	11
CERADYNE INC	\$417,616,849	86	CRDN	3290	14
AECOM TECHNOLOGY CORPORATION	\$380,250,228	91	ACM	8711	11
AT&T INC.	\$371,099,463	95	T	4813	11
KRAFT FOODS INC	\$367,840,952	97	KFT	2000	11
OWENS & MINOR INC	\$365,861,498	99	OMI	5047	11
CUBIC CORP.	\$354,623,567	102	CUB	3812	11
GREAT LAKES DREDGE & DOCK CORPORATION	\$324,475,211	113	GLDD	1600	14
CATERPILLAR, INC.	\$323,676,276	114	CAT	3531	11
PROCTER & GAMBLE CO.	\$321,983,149	115	PG	2840	11
TYSON FOODS INC	\$319,486,334	117	TSN	2011	11
VERIZON COMMUNICATIONS	\$319,365,283	118	VZ	4812	11
CHEVRONTEXACO CORPORATION	\$310,558,853	122	CVX	2911	11
SRA INTERNATIONAL, INC.	\$297,913,799	128	SRX	7370	11
GRANITE CONSTRUCTION CO.	\$292,263,100	131	GVA	1600	11
ACCENTURE	\$288,517,607	132	ACN	8742	11
JOHNSON CONTROLS, INC.	\$285,123,825	134	JCI	2531	11
EXPRESS SCRIPTS	\$215,750,049	162	ESRX	6411	14



CONOCOPHILLIPS	\$206,348,789	167	COP	2911	11
TYCO INTERNATIONAL LTD	\$202,567,751	172	TYC	9997	11
COMTECH TELECOMMUNICATIONS CORP.	\$202,082,670	173	CMTL	3663	14
GENERAL MILLS, INC.	\$200,017,932	176	GIS	2040	11
TESORO HAWAII CORPORATION	\$199,447,230	177	TSO	2911	11
AEROVIRONMENT INC	\$192,462,098	182	AVAV	3721	14
AAR CORP.	\$187,717,969	187	AIR	5080	11
SYSCO CORPORATION	\$179,074,006	195	SYY	5140	11
REFINERY HOLDING COMPANY L P	\$177,749,226	198	WNR	2911	11
DEERE & CO.	\$164,340,456	206	DE	3523	11
VIASAT, INC	\$156,815,300	217	VSAT	3663	14
ORBITAL SCIENCES CORP.	\$153,884,356	223	ORB	3760	11
PEPSICO INC	\$149,527,183	231	PEP	2080	11
UNISYS	\$142,990,124	239	UIS	7373	11
BALL CORP	\$131,696,095	259	BLL	3411	11
CONAGRA, INC.	\$125,264,234	270	CAG	2000	11
ORACLE CORP.	\$122,646,803	274	ORCL	7372	14
GENERAL MOTORS CORP.	\$120,929,817	279	GM	3711	11
EATON CORP.	\$117,792,917	286	ETN	3620	11
UNILEVER NV	\$112,089,508	292	UL	2000	11
MOOG, INC.	\$111,608,841	293	MOG.A	3728	11
ALON USA L.P.	\$111,102,800	296	ALJ	2911	11
COCA-COLA ENTERPRISES INC	\$93,991,833	343	CCE	2086	11
XEROX CORP.	\$91,275,424	356	XRX	3577	11
JOHNSON & JOHNSON	\$89,990,235	363	JNJ	2834	11
CAMPBELL SOUP CO.	\$88,645,010	367	CPB	2030	11
INTERMEC CORPORATION	\$83,566,808	388	IN	3577	11
CAE CORP	\$83,563,697	389	CAE	3690	11
DEL MONTE FOODS COMPANY	\$77,962,809	419	DLM	2000	11
AMERICAN SCIENCE AND ENGRG	\$76,545,302	429	ASEI	3844	14
MICHAEL BAKER CORP.	\$74,263,592	437	BKR	8711	12
KIMBERLY-CLARK CORP.	\$69,832,351	454	KMB	2621	11
ESTERLINE TECHNOLOGIES CORP	\$68,716,933	462	ESL	3823	11
INTEGRAL SYSTEMS, INC.	\$67,261,245	473	ISYS	7373	14
MINE SAFETY APPLIANCES CO.	\$67,166,647	474	MSA	3842	11
WORLD FUEL SERVICE CORP.	\$66,258,375	478	INT	5172	11
SARA LEE CORPORATION	\$65,361,053	482	SLE	2000	11
WILLIAMS COMPANIES INC	\$65,024,852	483	WMB	4922	11
HORIZON LINES LLC	\$65,008,856	484	HRZ	4400	11

Table1 shows that most of the firms in our sample are listed on the NYSE or NASDAQ, indicating that big defense contractors are likely to be established companies. For



each of the 96 firms, we use their stock ticker to map into the Compustat database and extract various accounting variables across a three-year range of 2007–2009. Note that our base year is 2008. The reason we include two additional years of data (i.e., 2007, one year prior, and 2009, one year after) is to expand the sample size and simultaneously ensure that the status of the top 500 defense contractors in 2008, as well as the political connections of the board members in 2008, can be assumed to be stationary and be passed onto 2007 and 2009 for the same firm, due to a short elapse of time. Expanding our sample to a three-year range yields a total of 276 firm-years, with 93 each for 2007 and 2009 and 90 for 2008. Following Wang and San Miguel (2012), we denote the excessive profit of a particular firm-year as the difference between this firm-year's return on assets (ROA)⁶ and the ROA of an "industry-year-size" matched benchmark firm that is not on the 112-firm list.⁷

Table 2 presents basic statistics of descriptive accounting measures for the 90 sample firms in Fiscal Year 2008.⁸ In particular, we report total assets, total sales (revenue), dollar awarded as percentage of revenue, and excessive profit as measured by the matched ROA. The mean values of total assets and total revenue were \$35 billion and \$33 billion, respectively. The government contracts contributed about 18% of these firms' 2008 revenue on average.⁹ Overall, these firms earned an excessive ROA of 3%, which is statistically significant at a 5% significance level, confirming Wang and San Miguel's (2012) findings that top defense contractors receive excessive profits relative to their industry peers.

⁶ To keep the paper concise, we exclusively use ROA as the profitability metric in this study. Other alternative profit measures yield similar results.

⁷ "The benchmark firm-year is selected based on a three-dimension match on industry, year and size. Specifically, we go to the same industry-year where industry membership is defined as four-digit SIC codes, and identify the non-defense (i.e., not on our 112-firm list) firm that has the best size match with our defense firm-year. The difference between the profit of the firm-year investigated and the profit of the benchmark firm-year will be the measure of 'excessive profit'" (Wang & San Miguel, 2012, p. 397).

⁸ We lost six firms for Year 2008 due to missing data from Compustat.

⁹ A concern that has been raised here is that a significant portion of our sample firms may have much lower than 18% of their total revenue that is attributable to DoD contracts, and hence, are not really "defense contractors" as the term is generally understood. Consequently, if Sara Lee had only 1% of 2008 sales from defense contracts, one cannot attribute much, if any, of Sara Lee's excessive profits to its defense contracts. We provide a few arguments to address the aforementioned concern. First, our sample focuses on DoD contractors, a much broader concept than a few prominent major weapon manufacturers. In that regard, an average 18% revenue from DoD is a reasonably decent number. Second, the central metric of our analysis is the excessive profit, and because profit is only a small portion of revenue, a relatively small percentage of DoD revenue could have a much larger impact on profit if firms do derive larger profits from DoD contracts than they can generate from their non-DoD business. Third, it is worth mentioning that the specific concern as expressed by using the Sara Lee example above is already addressed, if not completely removed, by our definition of the three-way industry-year-size matched excessive profit measure. In particular, if Sara Lee had a super good year for whatever reason that is non-DoD related, we expect that its benchmark firm, i.e., the firm that is in the same industry and has similar size (but without federal contracts), would also be impacted in a similar way and display a superior profit likewise in the same year. Hence, the excessive profit of Sara Lee, which is the difference between Sara Lee's profit and its benchmark firm's profit, would be only attributable to the fact that Sara Lee has DoD contracts while its benchmark firm has not. Last but not least, despite that we believe our current full-sample approach is sound, we nevertheless proceed to perform a robustness analysis, which only includes the subsample that consists of only those firms with at least 25% of total revenue generated from DoD contracts. Untabulated results show that all our findings are intact.



Table 2. The Basic Statistics of 90 Sample Firms in Year 2008

	Mean	Median	Min	Max	Std Dev
Total Assets (millions)	34,962	7,242	147	797,769	94,895
Total Sales (millions)	32,656	12,542	160	425,071	59,570
Dollar Awarded as Percent of Sales (%)	17.56	6	0.06	103.00	22.79
Excessive ROA	0.03	0.02	-0.18	0.32	0.10

Measuring Political Connections and Hypotheses Development

Measuring Political Connections

There is no unanimously agreed-upon definition of the term *political connection*.¹⁰ Scholars have used various forms of concepts in different research settings. For example, Mara Faccio, in a series of solo and coauthored papers,¹¹ defined a firm's political connection as follows: "A company is defined as being connected with a politician if at least one of its largest shareholders (anyone controlling at least 10 percent of voting shares) or one of its top officers (CEO, president, vice-president, chairman, or secretary) is a member of parliament, a minister, or is closely related to a top politician or party" (Faccio, 2006, p. 369). This definition by Faccio is not appropriate for any U.S.-based study because U.S. regulations pretty much rule out the possibility of anybody simultaneously serving a high-rank public service role and a top executive role in a private-sector firm. In the United States, if a present executive of a private-sector firm is appointed as a high-rank government official, he or she must quit his or her current job. As a testimony of this fact, Faccio (2010) found that under her definition, only 13 out of the 6,007 U.S. firms in the Worldscope database can be labeled as "politically connected firms." In short, this first definition applies more to international countries, such as Indonesia, Malaysia, or Italy.

The second definition of *political connection* focuses on campaign contributions and lobbying activities. For instance, Correia (2012) found that firms' political connections established by contributions to congressmen and by lobbying the SEC reduce those firms' enforcement costs by the SEC. Specifically, those firms are less likely to be investigated by the SEC, and even if they are investigated, the average penalty is lower for them. Other studies that adopted this definition include Roberts (1990), Kroszner and Stratmann (1998), and Ang and Boyer (2000). The problem with this definition is the low explanatory power. For instance, Goldman et al. (2009) found that controlling industry effect significantly reduces the explanatory power of campaign donation. Moreover, Jayachandran (2006) questioned the causal effect of firms' donations on firm value. To recap, the second definition, based on campaign donation or lobbying expenditure, at most provides a noisy measure of political connection.

The third alternative definition of *political connection* is derived from board directors' prior employment history in the federal government, including in the legislative, executive, and judiciary branches, and in the military Services. Since in the U.S., congressmen, government executives, and military generals are allowed to serve on the boards of private-sector firms after their retirement from public service (and they frequently do so), firms'

¹⁰ From this point on, we restrict our attention on political connections to private-sector firms rather than public states. One example of a public state's political connection was introduced previously.

¹¹ See Faccio (2006), Faccio (2010), Faccio, Masulis, and McConnell (2006), and Chaney, Faccio, and Parsley (2011).



political connections through board members receive substantial attention. Many U.S.-based studies follow the suit of this particular definition. To name a few, Agrawal and Knoeber (2001) found that firms for which politics plays a more important role tend to be more “politically connected” (i.e., they tend to have more politically experienced directors on their boards). Goldman et al. (2009) showed the market value relevance of the addition of a newly appointed, politically connected board member. Moreover, they differentiate between political connections to the Republican versus Democratic parties and provide evidence that the market values of these two different types of politically connected firms responded differently to George W. Bush’s 2000 presidential win.

Since our sample is strictly U.S. based, it is natural to follow the third definition of *political connection*. Specifically, we use the 2008 Directorships database that is provided by Corporate Library LLC. In this annual directorship dataset, Corporate Library records each individual director’s information through compiling data from firms’ publicly disclosed proxy statements. One key field in this database is a director’s biography, including detailed employment history. We use a series of keywords to search each individual director’s biography statement and identify whether this particular director is politically connected. The keywords we use are comprehensive to ensure a maximum catch of politically connected directors. The complete list of our search keywords follows: *senator, congressman, congresswoman, congress, representative, federal, secretary, admiral, general, army, navy, air force, department of defense, DoD, commissioner, ambassador, administrator, attorney general, governor, director, council*.

We apply this keyword search to the biography statement as of Year 2008 for each director who sits on the board of any of our 96 sample firms. Once we find a “hit” of a keyword, we read the biography and make sure this particular director is correctly flagged as one who is politically connected.¹² At Year 2008, our 96 sample firms have 989 directors in total, indicating an average board size of 10.3 directors. Out of these 989 directors, 923 are unique individuals, of which 157 are identified as politically connected directors. Put simply, 17% of the directors have prior employment history with the federal government or military Services. The data also indicate that 77 out of 96 firms have at least one politically connected director on their board; that is, 80% of our top defense contractors have some degree of political connection through the board of directors. To get a benchmark sense, it is worth mentioning that Goldman et al. (2009), using a very similar definition of *political connection* as our study, documented that at Year 2000, 153 of the S&P 500 companies (i.e., 31%) had at least one board member with a political connection. Therefore, the main message is that top defense contractors are much more likely to have a politically connected board than non-contractor firms.

¹² An example of a politically connected director’s profile is General John M. Shalikashvili, who served as a board director of L-3 Communications Holdings, Inc., at Year 2008. The following excerpt was from the company’s proxy statement: “General John M. Shalikashvili, director since August 1998 and member of the Compensation and Nominating/Corporate Governance Committees. General Shalikashvili (U.S. Army—Ret.) is an independent consultant and a Visiting Professor at Stanford University. General Shalikashvili was the senior officer of the United States military and principal military advisor to the President of the United States, the Secretary of Defense and the National Security Council when he served as the thirteenth Chairman of the Joint Chiefs of Staff, Department of Defense, for two terms from 1993 to 1997. Prior to his tenure as Chairman of the Joint Chiefs of Staff, he served as the Commander in Chief of all United States forces in Europe and as NATO’s tenth Supreme Allied Commander, Europe (SACEUR). He has also served in a variety of command and staff positions in the continental United States, Alaska, Belgium, Germany, Italy, Korea, Turkey and Vietnam.”



Hypotheses Development

In this subsection, we derive alternative hypotheses on the relationship between defense contractors' excessive profitability and their political connections, based on extant literature and observations. Most of the prior literature suggests the "corruption" role of political connection (i.e., the firms with political connections opportunistically take advantage of this favorable relation and inappropriately derive private benefits for the firm at the sacrifice of social welfare). For example, Duchin and Sosyura (in press) found that politically connected firms are more likely to get TARP funds, yet their performance was inferior to that of unconnected firms. This clearly indicates that political connection is a source of "corruption" and "inefficiency." Correia (2012) presented evidence showing that firms use their political influence to avoid the scrutiny of the SEC or mitigate the punitive damage in the case of financial reporting irregularity. Faccio et al. (2006) analyzed a unique dataset that covers 35 countries during 1997–2002 and found that those politically connected firms are far more likely to be bailed out during financial distress than non-connected firms in a similar economic crisis. Moreover, after bailout, those firms with political connections significantly underperform unconnected firms. Chaney et al. (2011) documented that politically connected firms have poorer earnings quality than their non-connected counterparts. All of the studies mentioned previously collectively convey a consistent message: that is, political connection is associated with various rent-seeking behaviors. Applying this corruption proposition of political connections to the defense contractors' excessive profit, we have the following hypothesis:

Hypothesis (H): The defense contractors' excessive profitability is more pronounced for those with political connections. Non-connected firms should exhibit a less excessive profit.

While this hypothesis sounds like a reasonable conjecture given all evidence in the extant literature, an alternative hypothesis nevertheless could exist. In particular, if defense contractors, a unique subset of universal firms, have different and non-opportunistic motives for establishing political connections, then the story could be very different. Given the unique nature of the defense procurement business, it is quite likely that commonality may not prevail here. For instance, one distinctive feature of defense-related business is the complexity of regulation, which often requires substantive professional and inside knowledge to truly understand. The Federal Acquisition Regulation (FAR) alone consists of thousands of pages full of government-specific terminologies. Further, a firm that is doing business with the Department of Defense (DoD) is under the scrutiny of various government agencies, such as the Government Accountability Office (GAO), the Defense Contract Audit Agency (DCAA), and others. There is a high cost of non-compliance. A defense contractor that is found to engage in misconduct could face various penalties including settlement with fine, civil or criminal investigation, suspension, or even debarment. If defense contractors believe that these redlines are costly to cross, they may have incentives to hire the best talent with professional and institutional knowledge to help them avoid such behavior. For example, a March 22, 1991, article in *The Wall Street Journal*, titled "Northrop Nominates Three for Its Board," reported that

The nominees are Joseph A. Califano Jr., 59 years old, a Washington attorney and former Secretary of Health, Education and Welfare under President Jimmy Carter; Jack Edwards, 62, a Washington lawyer and formerly the ranking Republican congressman on the Defense Appropriations Subcommittee; and retired Gen. John T. Chain Jr., 56, a 35-year Air Force veteran who this year retired as commander-in-chief of the Strategic Air



Command to become executive vice president of operations of Burlington Northern Railroad Co.

A company spokesman said in the news announcement, “[These] board members are chosen for the breadth of their experience and counsel” (“Northrop Nominates,” 1991). Moreover, Kent Kresa, then Northrop president and chief executive officer, further commented, “These men bring to Northrop unsurpassed experience and knowledge in their own fields, and a diversity that will serve us well as we shape the company to match the changes taking place in the country and the world” (“Northrop Nominates,” 1991). Note that two of the individuals are attorneys and all three of them had extensive and high-profile government or military experiences. Their expertise and experience, if used under good intention, would greatly help Northrop comply with the regulatory and executive rules. Recognizing this potential competing theory, we offer the following alternative hypothesis:

Alternative Hypothesis (AH): The defense contractors’ excessive profitability is less pronounced for those with political connections. Non-connected firms should exhibit a more excessive profit.

Both H and AH have reasonable justifications. Which one is factually supported? The next section empirically investigates this issue.

Empirical Results and Findings

Univariate Analysis

We first report the univariate statistics of key variables. Recall from the Sample section that we have 276 firm-years in a three-year range of 2007–2009. We classify each of these 276 firm-years into one of the two mutually exclusive groups. The first group, labeled as “non-politically connected” firms, consists of all firm-years for which none of a firm’s Year-2008 board members had political connection through his or her prior employment. All of the other firm-years that are not in the first group had at least one of the firm’s board members being classified as a “politically connected director” and hence belong to the second group called “politically connected” firms. Out of the 276 firm-years, 54 are politically non-connected and 222 are connected.



Table 3. The Univariate Comparison of Key Variables Between Politically Connected and Non-Connected Firm-Years

Group	N	Variable	Mean	Std Dev
Politically Non-Connected	54	Total Assets (millions)	13,535	23,945
		Total Sales (millions)	22,754	30,769
		Dollar awarded as percent of sales (%)	8.52	11.73
		Excessive ROA	0.04	0.09
Politically Connected	222	Total Assets (millions)	41,339	103,331
		Total Sales (millions)	33,060	56,377
		Dollar awarded as percent of sales (%)	21.59	28.00
		Excessive ROA	0.01	0.08

We have several immediate observations from Table 3. First, politically connected defense contracting firms are much bigger than non-connected ones. Measured by assets (revenue), a typical politically connected firm is three (one-and-a-half) times as big as a typical non-connected firm. Second, defense contracts account for a much bigger portion of total revenue for politically connected contractors than for non-connected ones. Specifically, about 21.6% (as opposed to 8.5%) of total revenue is generated by defense contracts for politically connected firms (as opposed to non-connected firms). This particular evidence is consistent with Agrawal and Knoeber (2001), who found that for those firms in which sales to government plays a more important role, the presence of politically connected directors on the board is greater as well. It is also in line with the finding of Goldman, Rocholl & So (in press) that political connections affect the allocation of procurement contracts. Nevertheless, we would like to stress that just because there is a positive association between the political connection and the defense contract dollar as a percentage of revenue does not necessarily indicate a rent-seeking or corruption story. It is plausible that the hiring of political experience is well intentioned and that those valuable experiences are legitimately used to compete for government contracts in a lawful and ethical way. Last but not least, a univariate comparison on excessive profits (as measured by excessive ROA) between politically connected and non-connected groups demonstrates that the former displays a much less pronounced excessive profit than the latter (4% versus 1%). This suggests that preliminary evidence casts doubt on the corruption (or rent-seeking) hypothesis and favors our alternative hypothesis, which supports the non-opportunistic motives for establishing



political connections. That said, a more sophisticated approach (beyond univariate analysis) is needed to provide more convincing evidence.

Multivariate Analysis

In this subsection, we use a multivariate regression method to examine whether the evidence against the corruption hypothesis in a univariate context persists in a multivariate setting. Put another way, we want to inspect whether our preliminary finding based on a univariate relation is robust to controlling all known determinants of defense contractors' excessive profits. Needless to say, our dependent variable (i.e., the left-hand-side variable) is the firms' excessive profits, and our main variable of interest on the right-hand side is the firms' political connections. To ensure that the impact of political connection on excessive profit is incremental to the effects of all the other known determinants of excessive profits, we need to include a set of control variables on the right-hand side of the regression. Wang and San Miguel (2012), a recent work on defense contractors' excessive profits, provided us with a reference for that purpose.

Wang and San Miguel (2012) not only confirmed the existence of defense contractors' excessive profits but also they document two determinants of excessive profitability. In particular, by showing defense contractors' excessive profits being more pronounced after 1992, they argued that the post-1992 significant industry consolidation improved the bargaining power of the newly combined firms and, in turn, amplified these firms' profitability. This basically indicates that the degree of industry concentration is a key determinant of excessive profit. The second determinant documented by Wang and San Miguel (2012) is the quality of corporate governance, as measured by the duality of the chief executive officer (CEO) and the chairman of the board. The main justification behind this relation is that poorer corporate governance exacerbates firms' rent-seeking behavior that arises from substantial information asymmetry between the government and defense contractors.

In addition to the two determinants from Wang and San Miguel (2012), that is, the degree of industry concentration and the quality of corporate governance, we also include the size of the firm as a third control variable. There are two reasons for doing that. First, firm size is a commonly used control variable in empirical corporate finance studies. The justification is that size is such a "composite" variable that incorporates so many characteristics and information that for any particular study, it is a noisy measure of the particular variable of interest, yet a universal and perfect control variable that is nice to be included on the right-hand side. Second, Table 3 clearly shows that there is a negative correlation between the size of the firm and the firm's excessive profitability, and a positive correlation between the size of the firm and the firm's political connection; that is, smaller defense contractors tend to exhibit more pronounced excessive profits and less political connection relative to bigger ones. Hence, it is appropriate to include the size of the firm as a control to avoid the potential correlated omitted variable problem that could damage the statistical inferences of the multivariate regression model.

So the multivariate regression includes three control variables besides the variable of interest (i.e., political connection). The dependent variable is, of course, the excessive profits as defined by a three-way industry-year-size matched excessive ROA,¹³ as elaborated in Wang and San Miguel (2012). The empirical proxies for the three control variables are as follows: we use a logarithm of total revenue as "firm size," the duality of CEO and chairman of the board as a binary measure of "corporate governance," and the

¹³ Where industry is defined as four-digit SIC code, size is defined as total assets. Alternative definitions yield similar results.



percentage of industry revenue represented by the largest four firms within the industry as a gauge of the degree of industry concentration. Same as Wang and San Miguel (2012), we extract total revenue from Compustat and assess whether the CEO is also the chairman of the board from firms' proxy statements. Regarding the proxy for the degree of industry concentration, we use the Year-2007 "Concentration Ratios" published by the Census Bureau of the U.S. Department of Commerce. Table 4 reports the regression results.

Table 4. Multivariate Regression: The Excessive Profitability and Firms' Political Connections

Independent Variables	Dependent Variable: Industry-Year-Size Matched Excessive ROA Excessive ROA= a+ b*political connection +c*corporate governance+ d*firm size+ e*industry concentration	
	Political Connection measured by a dummy indicator	Political Connection measured by the percent of politically connected directors in the Board
Intercept	0.05	0.04
Political Connection (t-value)	-0.04 (0.01)***	-0.07 (0.04)**
CEO-Chairman Duality Dummy (t-value)	0.01 (0.29)	0.01 (0.31)
Firm Size (t-value)	-0.08 (0.05)**	-0.08 (0.05)**
Industry Concentration (p-value)	0.10 (0.03)**	0.11 (0.02)**

Notes. * indicates 10% significance level, ** indicates 5% significance level, *** indicates 1% significance level; CEO-Chairman dummy takes value of one if the CEO is also the chairman; Firm size is defined as logarithm of total revenue; Industry concentration is defined as the percentage of industry revenue represented by the largest four companies within the industry.

Table 4 shows that excessive profitability is lower for those firms with political connections, regardless of whether political connection is measured as a binary indicator variable or as the percentage of politically connected directors on the board. The magnitude of the impact is both statistically and economically significant. Moreover, this result holds after controlling other known determinants of excessive profits. The signs of all the control variables are as expected, and the magnitudes of the coefficients of control variables are significant except for the corporate governance proxy. Overall, the multivariate regression results reject the corruption or rent-seeking hypothesis and suggest a non-opportunistic motive of establishing political connections through board directors' prior experience.

Conclusion

Using a slightly reduced sample from the one used by Wang and San Miguel (2012), we investigate the impact of political connections on excessive profits of defense contractors. We measure political connections by searching the biographies of board directors in the firms' proxy statements. We find that defense contractors are more likely to have politically connected director(s) in their board; moreover, among defense contractors, those with a politically connected board tend to have a higher percentage of revenue from defense contracts than those without political connection. While the evidence may suggest that defense contractors have stronger incentives to establish political connections through



the recruitment of board directors, and those directors may indeed help the firm to compete for government contracts, they do not necessarily support a “rent-seeking” or “corruption” hypothesis. In fact, in testing the “corruption hypothesis” versus an alternative “non-opportunistic motive hypothesis” in the setting of defense contractors’ excessive profits, we find strong evidence refuting the former and in favor of the latter. This suggests that defense contractors may hire those politically connected directors and use their experience to serve a benevolent role to the public. For instance, one legitimate use of the political experience is to keep defense contractors from opportunistic profit-seeking behaviors that could reach or even cross federal government regulatory redlines.

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